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ASIC's focus on hedge funds may miss bigger picture

David Bell

After a long consultation period, ASIC has amended its regulatory guidance relating to hedge funds (RG240) to focus on "… those funds that pose more complex risk to investors". I discussed ASIC's previous version on improving hedge fund disclosure in Cuffelinks on 1 April 2013. Many others raised concerns, with the prize for the most colourful title going to Mallesons with their, "*Who'd be a hedgie? Could new reforms regulate hedge funds out of existence*?"

Since then, ASIC continued to extend relief from the disclosures required under RG240 and in October 2013 released an updated version, to commence from 1 February 2014. ASIC Commissioner Greg Tanzer was quoted as saying, *"Our changes will benefit the industry by relieving some lower-risk funds from the more extensive disclosure obligations imposed on a hedge fund under RG 240."* From this comment the intention of the disclosure is evident: to create more extensive disclosure obligations for hedge funds, thereby protecting potential investors.

Revisions in ASIC's updated version

What are the changes? The updated version of RG 240 makes only subtle changes to the definition of a hedge fund, in response to feedback from some groups that want to avoid this label. The broad definition of a hedge fund remains (full details here), namely a fund which promotes itself as a 'hedge fund' or one that exhibits two or more characteristics of hedge funds, the five

characteristics being: complexity of investment strategy or structure, use of leverage, use of derivatives, use of short selling and charging of a performance fee.

The changes in the updated RG240 only apply to the descriptions of these characteristics:

- under the characteristic of 'complexity of investment strategy', benchmarking to a blend of traditional market indices (such as traditional multi-asset class funds) is now excluded as a characteristic of a complex investment strategy
- under 'complexity of structure', ASIC has clarified the definition of interposed entities (ASIC views too many interposed entities involved with the end product as a characteristic of a hedge fund) to relieve those parties using an authorised investment vehicle in a foreign jurisdiction
- under 'use of derivatives', ASIC now does not consider the use of exchange-traded derivatives where the notional derivatives exposure does not exceed 10% of a fund's net asset value as a defining characteristic of a hedge fund.

Extra disclosures for 'hedge funds'

As discussed in my previous article, if a fund is deemed to be a hedge fund then it faces more significant disclosure requirements in the areas of:

- investment strategy: detail of the strategy, exposure limits
- investment manager: increased disclosure around key staff, qualifications, background, employment contracts
- fund structure: detailed disclosure around the structure of the fund and service providers, and fees through the structure
- custodial: valuation, location and custody of assets, custodial arrangements, and a list of all instruments and markets traded
- liquidity: description of liquidity policy and any illiquid positions
- leverage: disclosure of leverage and possible ranges
- derivatives: a fair amount of disclosure required
- short selling
- withdrawals: disclosure around withdrawals and associated risks.

These areas of disclosure are what ASIC calls benchmarks and disclosure principals. ASIC advises that every PDS for a hedge fund should meet these disclosure requirements. However a responsible entity can adopt an 'if-not-why-not' approach where they do not disclose on a particular issue and clearly explain why they didn't disclose and the risks this may create for investors. Of course ASIC may choose to not approve PDS's with insufficient disclosure.

Will RG 240 work? If the objective of ASIC is to avoid repeats of the types of losses we saw with Astarra Strategic Fund and Basis Yield Alpha Fund, then RG 240 will assist but will not guarantee repeats of these events. ASIC's model is to seek disclosure and then leave the rest to the (now presumed to be informed) investor. The investor can choose to use or not to use this additional information. Lack of investment knowledge and the behavioural biases that exist in investing will undoubtedly ensure future disasters.

What are some of the consequences?

Financial planners may 'discover' they have clients invested in hedge funds. Do they have to change their Statement of Advice? Will PI (professional indemnity) insurance bills be higher for financial planning groups which include hedge funds on their approved products list? If they change client portfolios as a result, there may be capital gains tax realisations.

The underlying hedge fund managers will be most affected. Some of the disclosures affect their ability to run their business (for instance they have to list key people and outline some details of their employment contracts), raise assets (the financial planning community may be deterred from recommending hedge funds) and protect their investment strategy (disclosure of instruments and use of leverage may give competitors some insight as to their strategy). I am not overly concerned about any changed perception of the hedge fund industry – it is full of complex products.

My main concern is that the term 'hedge fund' is used as the parking bay label for complex investments. The complementary set of investment products to those defined as 'hedge funds' will contain many investments which are complex. People may incorrectly regard investments which are not hedge funds as not being complex. Consider just a few: geared share funds, the range of equity income funds that use derivatives, new-age total return balanced funds, the more flexible fixed income and cash funds, the list goes on ... There are complex funds all around yet they may not be labelled as a hedge fund.

Better to focus on 'complexity'

In my submission to ASIC for RG 240, I suggested that instead of focussing on hedge funds there was a one-off opportunity to focus on investment product complexity itself. Instead of defining hedge funds, ASIC could define complexity (for example a 'complex' investment may only require one of the five characteristics listed above), and disclosures appropriately designed. Funds could then label themselves as they like and 'hedge fund' would not be held out as the area where all the complex investments funds reside.

This type of approach would take the stigma out of complexity. These 'complexities' are usually used for a positive reason – to enhance returns or manage risks - but also highlight that extra consideration is required by investors. Investors would become more aware that many products have elements of complexity to them. It would also reduce 'regulatory arbitrage' where the provider designs a product to avoid being caught under particular regulations. Finally, as new products and categories are created, there is an over-arching definition of complexity that would catch these products rather than ASIC having to develop specific guidance.

Overall, while RG 240 will assist investors to be more aware when they are considering a hedge fund investment, I can't help but feel it is an opportunity lost in terms of the bigger picture of investor protection in a world of complex investments. By focusing so hard on hedge funds specifically, I think ASIC have missed a good opportunity to establish safety net disclosures for complex investments.

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Don’t leave your estate to clean up a super mess

Donal Griffin

SMSFs have continued to grow in number despite, or perhaps because of, the global financial crisis. People establishing these funds want to take control of their finances and would like that control to extend to who receives the money left behind after they die.

The ability to nominate beneficiaries for superannuation is restricted by the Superannuation Industry (Supervision) Act 1993 (*SIS Act*) and related legislation and regulations. Many people may not be aware that they cannot validly nominate a friend, a charity or any person who is not a ‘dependant’, or their estate, to receive their superannuation.

Conflicts over inherited superannuation

In our experience, superannuation is increasingly becoming an asset that attracts the attention of disappointed people who expected to be beneficiaries of a substantial member balance.

Such people are dismayed to discover that they may not have been treated the same as their siblings by a parent or, more annoyingly, by a third party professional super fund trustee when it comes to dividing up the super balance of a deceased SMSF member. Often, one of deceased's children, as the executor, steps into the shoes of the SMSF trustee. The bad news for other siblings is that, if there is no valid binding nomination in place, then unless a will directs that adjustment be made for superannuation payments, executors can pay the super to themselves with impunity.

Some will be outraged by this, but the law is fairly settled in this area. Freedom of testation in Australia has for more than a century been restricted by legislation that allows a broad range of people to challenge a will. Ignoring the reality of potential claims can put the person managing an estate under terrible stress and financial pressure as they are liable to be sued by disappointed parties.

The only way to have certainty with superannuation is to ensure that binding nominations are in place and up to date; they usually lapse every three years.

Regulation 6.17A of the SIS Regulations sets out in detail the requirements that must be included in the notice for non-SMSFs, including the fact that this must be in writing and signed and dated by the member in the presence of two independent adult witnesses. Wills and estate lawyers are continually amazed by how many unwitnessed or undated nominations they see. People assume their wishes are clear, but often they are invalid.

SMSFs provide flexibility and certainty, but trustees should realise that SMSFs come with added responsibilities compared with other types of superannuation. In fact, the terms ‘self-managed’ and ‘DIY’ are disingenuous. Professional support is usually essential.

While nominations need to be updated in writing every three years, there are also good tax reasons for checking them annually. For instance, if a nominated child beneficiary turns 18 and is no longer financially dependent, 16.5% tax will apply to any taxable benefit they receive.

Who makes the determination?

If there is no binding nomination that is valid, then the trustees of super funds make the beneficiary determination. However they need to follow due process. When we see disputes, allegations are often made around the trustees making a determination without following due process, in terms of notices, quorums for meetings, analysis of reasons given, resolutions, etc.

We are seeing instances of trustees of public offer funds paying super out to legal personal representatives of estates that may be the subject of a legal challenge, or to de facto spouses where it seems clear that these relationships had ended before the time of death of the members concerned. Decisions in such situations can be surprising and disappointing, depending on your position.

In most cases, particularly if there is a dispute about who should apply to be the legal personal representative (that is, a spouse versus a de facto spouse, or one child of the deceased versus another), it would be prudent to be clear who the legal personal representative is. Some cases show that there has been confusion as to whether a death benefit is paid to a person in their capacity as legal personal representative or in a personal capacity.

What is a valid binding death benefit nomination?

People find the tax environment of SMSFs attractive. However, they are less excited by the fact that there are a limited number of people to whom they can pay their superannuation on their death. In particular, it is usual for them to arrange to pay a pension or a lump sum to a spouse but, just as commonly, they may want to impose controls over that spouse's use of the money, with a view to it being available for their children when their spouse passes away. Superannuation is an excellent asset accumulation vehicle but it is not necessarily a ready asset transfer vehicle.

Regulation 6.22 of SIS Regulations 1994 states that benefits must be paid to either or both of the following:

(a) the member's legal personal representative, or

(b) one or more of the member's defendants.

Regulation 6.17A sets out all of the requirements for paying out benefits on or after the death of a member. Cases reveal that compliance is mandatory and strictly monitored. Technical breaches will not be smoothed over and nominations with such breaches will be invalid.

Common errors with the nomination are that they are undated, the member has signed their date of birth as the date at the time of signing, or witnesses have not signed at the same time, or at all. We also see a number of trust deeds that predate 1999 and they do not allow for binding nominations. This means that nominations are not possible in that fund.

Adult children rarely satisfy the dependancy rules. Accordingly, a rule of thumb when preparing binding nominations may be that proposed beneficiaries need to be under 15 years of age where there is the usual three year nomination period, as if they are over 15 years, it is possible that they would become a non-dependant (that is, already over 18) at the time of death while the nomination is still valid.

Don’t leave your estate in confusion

Judicial authorities are demanding strict compliance with the regulations. If they are not followed correctly in the first instance, there is usually no opportunity to ‘fix’ any problems that may arise. Superannuation nominations are quasi-legal documents but are often not drawn up by lawyers, or executed in front them. We suggest that a senior adviser supervise every step of a nomination from consideration of the different ways to protect beneficiaries to the execution of a document that is designed to achieve the important task of distributing deceased members' superannuation wealth in accordance with their wishes. Beneficiary nomination for superannuation is a mine field that can be traversed safely and profitably.

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Death duties, where angels fear to tread

Ramani Venkatramani

If advocating additional taxation is unpopular with the public, little provokes as much antagonism as the mere mention of death duties. In Australia, it is a truism that any leader contemplating death duties must be morbid, endowed with a fetish for political suicide.

I believe it is time to question this superstition. Holy cows need periodical poking in the ribs, however anathematic to the faithful.

Government revenue growth must come from somewhere

Given the outlook for budget deficit, global uncertainties and political point-scoring about 'the other side's tax grab', treasurers and civil servants have been forced to conjure up incremental measures from a list of possibilities of diminishing utility. In superannuation, the superannuation surcharge (which its architect Costello later contritely despised), the complex contribution caps and the proposed taxation of earnings during pension phase exceeding $100,000 per member come to mind.

It is naive to ignore a potential source that remains untapped for reasons of apathy, inertia or false ideology. The pressure to plug the deficit is unrelenting, while pensioners post 60 receive tax-free benefits from tax-exempt accretion of savings. Social security asset limits ignore the family home, which remains exempt from capital gains tax as the primary residence.

Dislike of death duties

Why the antipathy to death duties? Several reasons suggest themselves:

- Having accumulated assets during life after paying taxes, it seems a double whammy to extract another dose.
- Such taxes will be a disincentive for people to work harder, earn more, prudently save for a rainy day during life and arrange for the eventual care of the family – all attributes of a civilised, as distinct from subsistence, society. Progress and social cohesion depend on them.
- People already suffering from the trauma of the demise of a dear relative do not need the angst of the savings of a productive life, being dissipated by the grasping taxman.
- There is something morbid, redolent of grave digging, in extracting taxes from the dead. Are we that low to pick, hyena-like, on our dead?

On closer scrutiny, many of these legitimate convictions exhibit the classic features of ancient myths no longer relevant in, or affordable to, contemporary society. Consider the following:

- Society incurs a cost in facilitating the orderly enjoyment of accumulated assets, regardless of the owner's physical existence, and this has to be paid for. Why not seek a contribution from the users? Multiple incidence of taxation is not as uncommon as the argument presumes: for example, consumption of post-tax income is subject to a variety of cascading taxes. Therefore, it is a question of distributing the impost equitably across a range of taxable amounts, including bequests. The larger the taxable base, the better.

- The progressive system of taxation, almost universally preferred, does entail more from the better off, as a proportion of the taxable base. The alternatives (regressive and flat systems) will impose a heavier burden on the lower earners. It is possible to set tax rates such that the desired goals (incentives for work, prudent savings and providing for the family) are balanced against a fair and reasonable levy, without treating the two as mutually exclusive.

- The argument of additional trauma for the family is disingenuous, at best. As long as the tax rate is set unambiguously and administration simple, those remaining can and should consider the net of tax legacy in remembering the deceased. Bequests incur a host of other costs: professional fees, stamp duties, custody and execution charges. No one begrudges them. Inheritance taxes merely conjoin the twin certainties of life in one convenient step.

- Bemoaning the dissipation of wealth upon death ignores hard reality: death deprives humans of all physical possessions. Why pretend inheritance is an exception? The obvious motive is the entitlement mentality of those who remain.

- The conflation of inheritance tax with the purported ill-treatment of the departed conveniently glazes over the fact that in the astral world beyond, the ATO writ does not run. As we find it acceptable to tax the living to foster social order and equity, even if it results in severe hardship to the lower levels of economic strata, it must be a no brainer to 'tax the dead'.

The arguments for death duties

The arguments in favour of the tax are:

- The criteria for a good tax system are equity, ease of collection, re-distribution of income and wealth, capacity to pay, incentive to earn and efficiency, combined in optimal balance. The imposition of inheritance tax would not offend any of the above.

- Tax avoidance is a major problem that deprives the exchequer of money, time and effort. Given the existing system of distributing deceased estates, it should be relatively easy to guard against abuse, with appropriate recourse against the inherited assets.

- Tax is global in its reach. Those tempted to game the system across national economies because of Australia's current practices might find it is less advantageous, if the inheritance anomaly is corrected. While this might call for an incremental tweak of the system, it would be worthwhile to preserve equity.

- Most of all, the emerging outlook cries out for a replacement of the current system's propensity to push funding costs as a future burden on successive unborn generations. Consider unfunded social security and government pensions on the one hand and the need for a government push into long term infrastructure funding (even if it is as a co-investor with other long term investors). There is something amiss in a society that taxes the average worker on incomes of $37,000 per annum, while letting current consumers past their working lives to enjoy tax-free pensions and lump sums, regardless of size, and then able to pass on the balance gross of tax to their offspring. It is neither welfare nor equity. Ignoring inheritances misses a vital option.

In superannuation, the nation is faced with managing longevity as more members move into the pensions phase, free of earnings and benefits tax. We need a circuit breaker, in addition to innovative policy. Inheritance taxes could be the circuit breaker.

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Index versus active? Nobel Prize professors can't agree

Graham Hand

The 'index versus active' investing debate is one of the oldest arguments in the industry. On one side, researchers point to the legends of the market (think Buffett, Templeton, Lynch, Gross) who have outperformed a market index over long time periods. On the other side, as many brilliant minds point to statistics which show the majority of active managers underperform the index after fees over long time periods, and of course there will be some above average in a sample of thousands - that's how probabilities work in any game of chance.

The debate had another run this week when the Nobel Prize for Economics was shared by world-renowned professors with opposite views. In one corner is Professor Eugene Fama, who gave us the modern efficient markets theory that share prices incorporate all available information and there are no mispricings to exploit to consistently deliver outperformance. Fama's conclusion in his paper (with Kenneth French), *Luck versus skill in mutual fund performance*, was:

"Going forward, we expect that a portfolio of low cost index funds will perform about as well as a portfolio of the top three percentiles of past active winners, and better than the rest of the active fund universe."

The other Nobel winner, Professor Robert Shiller, says of efficient markets, "the theory makes little sense, except in fairly trivial ways", and he draws on behavioural science to show the human errors involved in market pricing. He emphasises the extent to which individual investors misperceive and overreact to information.

Outperformance comes in many guises. Rosalind Hewsenian, CIO of a major US charitable trust and an investment consultant from 1985 to 2006, in this excellent article called '*Beating the market has become nearly impossible'* (Institutional Investor, 18 September 2013), says:

"Most of my career was dominated by the twin rallies of the stock and bond markets. Alpha was generated by simply tilting risk a little higher than the markets generally and you could outperform." (Note: alpha is a measure of excess returns).

Most asset manages do not accept such a humble and self-deprecating explanation.

About 80% of securities listed on the ASX are owned by institutional funds, domestic and foreign, each managed by highly qualified and skilled experts. There are thousands of stock pickers and analysts, all educated at the best universities in the world and most with decades of experience. They are the market and they own the index, and some will underperform and some will outperform. A few will look really good, and they will win awards and attract money. But how do we separate skill from chance? For example, the probability of making 60 correct guesses out of 100 coin tosses is about 2.8%. So if we have, say, 100 participants who guess a coin toss every month for 10 years, about three of them will correctly guess 60 out of 100. Are these the celebrated fund managers who have outperformed all the others? Surely, a decade of excellence in coin-tossing proves their added skill. But then what happens next year, on the next set of tosses?

The latest 'Index Versus Active' scorecard

So it is opportune that in the same week as the Nobel Prize announcement, the updated SPIVA scorecard was released. This is a tortured abbreviation for the Standard & Poors' (SP) Index Versus Active (IVA) scorecard. The report is issued semi-annually, the latest for mid-year 2013, and it tracks the performance of actively-managed Australian funds versus their benchmarks, corrected for survivorship bias.

The comparisons of active versus index over only 12 months are not much value. For example, in the year to 30 June 2013, 60% of active Australian equity funds outperformed the S&P/ASX200 Accumulation Index, but in the previous year, 70% underperformed over one year. Longer time periods must be studied.

The results over five years, summarised in the table below, are:

- the index outperformed over 60% of active Australian equity funds, and over three years, 68% of managers lagged their benchmarks
- 82% of small cap Australian equity managers actually outperformed their index. This occurs over all periods studied in the report. There are two reasons usually given why small cap managers consistently outperform their index. First, the index includes many speculative small resources companies with a dream but no decent cash flows, which eventually collapse, and managers often avoid these disasters. Second, small caps are less analysed than ASX100 companies, and it is possible to identify undervalued gems with excellent prospects.
- 79% of active international equities underperformed their index, and 88% over three years
- 64% of active Australian bond funds failed to beat their index
- 60% of active Australian A-REIT funds failed to beat their index (and 87% in the last year)
- Only 81% of the asset managers from five years ago still exist.

It's not much of a scorecard for the millions of hours of number-crunching and company visits by talented active managers. Or are they all so talented that they cannot beat each other?

Report 1: Percentage of Funds Outperformed by the Index

Fund Category	Comparison Index	One-Year (%)	Three-Year (%)	Five-Year (%)
Australian Equity General	S&P/ASX 200 Accumulation Index	36.42	67.63	60.41
Australian Equity Small Cap	S&P/ASX Small Ordinaries Index	6.12	11.54	18.10
International Equity General	MSCI World Ex Australia Index	75.52	88.04	78.97
Australian Bonds	UBS Composite Bond Index 0+Y	37.74	67.27	64.29
Australian Equity A-REIT	S&P/ASX 200 A-REIT Index	86.96	79.80	59.22

Source: S&P Dow Jones Indices, Morningstar. Data as of June 30, 2013.

Ironically, S&P believes active management provides a useful role, since the massive amount of research undertaken keeps prices close to fair values and allows index investors to take a free ride without paying the costs. They call this a 'fragile equilibrium', and quoting William F Sharpe:

"Should you index at least some of your portfolio? This is up to you. I only suggest that you consider the option. In the long run, this boring approach can give you more time for more interesting activities such as music, art, literature, sports and so on. And it very well may leave you with more money as well."

It's your call, depending on who and what you know. If you think you can identify the few managers who outperform the index consistently over time, either by research or based on advice, go for it. At least you'll have more fun watching him (it's always a man) explain the variability to the index and why his style did not work last year. If you don't have an opinion, or don't have the time, stick to an index. If there's one thing you can control, it's the cost, and the wide range of index funds now available allows wide choice to implement most asset allocation strategies.

A fortune built on defying the pull of theory

John Kay

(This article from The Financial Times *in 2004 shows how little has changed in the 'active versus index' debate in the last decade, but at least we reach the same conclusion).*

The efficient market hypothesis is 90 per cent true, and you will lose money by ignoring it. However, judging by Warren Buffett's fortunes, a few skilled searchers might find rewards in the remaining 10 per cent worth chasing.

You have probably heard the joke about the economist who is walking along the street when his wife points out a $10 bill on the pavement. "Don't be silly," he replies, "if there was one, someone would already have picked it up."

The joke is more illuminating than funny. The economist is, of course, right. There are very few $10 bills on the pavement, for precisely the reasons he identifies. People rarely drop them and when they do the money is quickly picked up. If you see a $10 bill on the pavement, it is probably a piece of litter that looks like a $10 bill. You would not be well advised to try to make a living tramping the streets in search of discarded $10 bills.

The story is intended to mock the commitment of most economists to the efficient market hypothesis – the theory that it is hard to make money by trading because everything there is to know about the value of shares, currencies or bonds is already reflected in the price. A corollary is that share prices follow a random walk – past behaviour gives no guidance as to the direction of future changes, and the next market move is always as likely to be down as up.

Efficient market theory is central to modern financial economics, which has long been the jewel in the crown of the business school curriculum – it combines technical rigour with practical applicability and its successful practitioners command large salaries in financial institutions. In 1978 Michael Jensen, doyen of efficient market theory, famously wrote that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis".

So it comes as a shock when the latest rich list from Forbes reveals that Warren Buffett has collected $44 billion by finding $10 bills among the trash on the pavements of Wall Street, and now rivals Bill Gates for the title of the world's richest man. Mr Buffett's investment success has long troubled efficient market theorists. He himself noted that if 250 million orang-utans kept flipping coins, one of them would produce a long string of heads. But if the lucky orang-utan keeps tossing heads even after you have picked him out from the crowd, that suggests he knows something you do not.

And so it is with Mr Buffett. In 1999 smart operators thought his luck had run out and sent Berkshire Hathaway shares to a discount on asset value. Mr Buffett eschewed technology shares, explaining that he would not invest in things he did not understand. As usual, he had the last laugh.

Paul Samuelson, who is to economics what Mr Buffett is to investment, published a Proof that Properly Anticipated Prices Fluctuate Randomly, but hedged his bets by investing in Berkshire Hathaway stock. Almar Alchian, a Chicago economist, eager as ever to show that only government regulation gets in the way of market efficiency, attributed Mr Buffett's success to anomalies in Nebraskan insurance law. But it seems unlikely that these could generate a fortune that is about equal to the entire income of the state.

Advocates of efficient market theory confuse a tendency with a law. As Mr Buffett himself has put it: adherents of the theory, "observing correctly that the market was frequently efficient, went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day". The joke demonstrates why this must be the case. There is a contradiction at the centre of the efficient market hypothesis. There is no point bending down to pick up a $10 bill because someone will have done it already. But if there is no point in bending down to pick it up, it will still be there. In an article published just after Mr Jensen's, Joe Stiglitz demonstrated that contradiction, in many lines of mathematics rather than the single line of the stand-up comic, and this was one of the contributions for which he received the Nobel Prize for economics.

But for everyday purposes, it is quite enough to know the story of the $10 bill and its unexpectedly complex interpretation. The efficient market hypothesis is 90 per cent true, and you will lose money by ignoring it. The search for the elusive 10 per cent, like the search for discarded $10 bills, attracts effort greater than the rewards. But for the very few skilled searchers, the rewards can be large indeed.

This article first appeared in The Financial Times *on 24 March 2004 and was sourced from www.johnkay.com. John Kay is a long-established British journalist and author.*

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